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SUBJECT: TURKISH MARKETS RALLY ON HOPES FOR A CYPRUS
SOLUTION

¶11. (U) Summary: Turkish markets, especially the stock exchange, have soared this week on the encouraging news out of New York regarding Cyprus. Turkish markets attach particular importance to the Cyprus issue because it is linked to Turkey's EU accession prospects. As of mid-day Friday, Turkish equity markets had risen 13 percent this week. End Summary.

Markets Soar...

¶12. (Sbu) Turkish financial markets have soared this week on the encouraging news on the Cyprus discussions at the U.N. As of mid-day Friday, the IMKB 100 stock exchange index had risen 13 percent this week, from 16,965.83 at last Friday's close to 19,098.69 in mid-day trading Friday. The lira--already strong in recent weeks--has also resumed its appreciation, strengthening from TL 1.334 million at last Friday's close to TL 1.317 at mid-day Friday, the 13th. The Euro rally against the dollar exaggerates the lira/dollar appreciation, but even against the Euro, the lira has risen slightly from TL 1.696 to TL 1.691 during the same period. In the government securities market, Turkish Eurobonds have rallied but the benchmark domestic government bond's interest rate has eased only modestly from 24.76 percent at last Friday's close to 24.27 percent mid-day on the 13th.

...On Better-than-Expected news on Cyprus Talks

¶13. (Sbu) Turkish markets have a tendency both to be volatile and to pay particular heed to geo-political developments, viewing the extent of international (EU, U.S., IFI) support as critical to Turkey's financial prospects. In the case of the Cyprus negotiations, the link to Turkey's economic and financial health is particularly close because EU leaders have stated that a Cyprus solution--while not an explicit condition--will facilitate Turkey getting a date for EU accession negotiations. What was particularly cheering for markets about this week's developments was: a) the New York talks went better than expected, and b) the Turkish side was seen as less obstructionist than anticipated. Note that Istanbul analysts have told econoffs that the market expectation was either for no progress on Cyprus or very little.

Stock market rises far more than Fixed Income Market

¶14. (Sbu) Though the fixed income market benefited from the rally, the rise was far more pronounced in equities. Post contacts divide into two schools of thought on this. One perennially skeptical long-time Istanbul market-watcher attributed the dramatic rise to manipulation by the handful of market-makers in stocks. According to this contact, this small group tried to spark a rally in early January but had to retreat, and is now taking advantage of the good news on Cyprus to run the market beyond where valuations would justify. To an extent, this tracks with economist Guven Sak's comment to Econcouns that the U.S. war in Iraq and prospects for EU accession have meant that Turkish financial markets no longer reflect economic fundamentals, but are being driven in part by moral hazard. Central Bank Governor Serdengec has also made similar comments.

¶15. (Sbu) The other school of thought is that prospects for Turkish financial markets are strong through at least this summer, and that the preferred "Turkey play" is equities.

Both a visiting American hedge fund investor and an Istanbul financial analyst have told econoff that equities are preferable because they hold more upside potential whereas debt instruments can't appreciate too much further in the near term. The financial analyst said the most optimistic scenario would only have the benchmark interest rate falling to around 20 percent in the next couple of months, whereas stocks could rise another 15 percent or so.

¶16. (Sbu) Interest rates in the domestic fixed income market may also be bumping up against the floor created by Central Bank rates. Several analysts and officials have told us the only way government securities are able to trade so far below the Central Bank's 27 percent overnight rate is that banks--the primary holders of government securities--are betting on rate cuts in the coming months; otherwise they will have a "negative carry," i.e. their funding costs will exceed the interest earned. The markets began expecting a Central Bank rate cut in November, however, the Central Bank has been reluctant to cut rates in the face of doubts about the GOT's commitment to fiscal restraint. Last week, faced with better-than-expected inflation numbers for January, the Central Bank finally announced a grudging 200-basis point cut but warned about the need for fiscal restraint. Many analysts expect further cuts if and when the IMF and GOT reach agreement on the Seventh Review and a package of fiscal measures to cover the projected 2004 shortfall.

¶17. (Sbu) It was not clear how much of the rally stemmed from foreign buying, though foreign inflows were certainly a factor. A central bank official told econ specialist at least \$250 million flowed into the Turkish market this week, particularly on Tuesday and Wednesday. Given that the lira strengthened despite strong demand for foreign exchange from Turkish oil importers BOTAS and TUPRAS, the central bank official suspects there may have been as much as \$500 million coming into Turkish lira this week.

Non-Cyprus news mixed this week:

¶18. (Sbu) Aside from Cyprus, other news this week would normally have been a negative for the markets. One of the few privatization deals that looked like it might actually go through--the sale of the Tupras oil refinery--began to look dicier this week. The minority shareholders in Tatneft, the Russian oil company whose German-based affiliate Efremov Kautschuk GmbH leads the consortium buying Tupras, have threatened to sue Tatneft, citing financial problems arising from the Tupras purchase. Separately, Central Bank Vice Governor Sukru Binay recently pointed out to econoffs that Tatneft's local partner, the Zorlu Group, has companies that are de facto bankrupt participants in the World Bank-sponsored "Istanbul Approach" debt workout process. Though the Tupras sale is still expected to go through, worries have increased over the financial wherewithal of the buyers.

¶19. (Sbu) Also negative for Turkish markets was the news that the influential U.S. investment fund, CALPERS, announced that it had cut Turkey, along with Argentina and Peru, from its list of emerging markets in which it would invest. According to CALPERS methodology, Turkey scored poorly on human rights and accounting standards, among other criteria.

¶10. (Sbu) One bit of good news for markets was the--still unconfirmed--report that the IMF Seventh Review mission would return to Turkey next week. Since the press report of the IMF return first appeared late Thursday, after the big Wednesday-Thursday rally, this news was too late to be a factor.

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